HAYES KNIGHT | AUDIT

17 July 2012

Assurance for Larger Registered Charities
Competition, Trade and Investment Branch
Ministry of Economic Development
PO Box 1473
Wellington

Via email: financialreporting@med.govt.nz

Submission regarding Auditing and Assurance for Larger Registered Charities discussion paper released April 2012

Thank you on for the opportunity to provide comments on your consultation document.

We at Hayes Knight also appreciated the opportunity to engage directly at the joint ANGOA/MED meeting held in Auckland. We trust that the MED saw the benefit in this direct engagement approach and believe it would be a useful model for communication on a variety of future issues of market importance.

We are happy to elaborate on, or further explain any of our comments in this submission. Any questions with regard to this submission should be referred to the writer via (09) 367 1654 or craig.fisher@hayesknight.co.nz

Yours sincerely
HAYES KNIGHT AUDIT NZ

Craig Fisher

C. R. FISHER
Chairman
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About Hayes Knight

Hayes Knight are a mid tier chartered accountancy and business advisory group operating out of three offices based in Auckland. Two of these offices are dedicated to providing accounting compliance, business advisory and taxation services. The third office is our dedicated audit and assurance practice, Hayes Knight Audit NZ, which is led by three specialist audit directors and currently has a full time specialist audit and assurance team of over 30. Our audit client base essentially represents a snap-shot of the New Zealand economy ranging across most sectors and entity types. This currently includes a range of smaller issuers, numerous SMEs, and several large private entities. We also are approved auditors of the Auditor General with a significant number of audit clients in the education sector. Lastly and most relevant to this consultation we have a significant specialisation in the not for profit sector with clients right across the sector both in terms of size, and type. Charities are a subset of this sector.

Hayes Knight also provides training and a technical support service to over 50 smaller accountancy practices some of which provide audit services. We also provide formal audit peer support services for other auditors, in addition to being the authors of the *Practical Auditing Manual* published by Brookers/Thomson Reuters.

Our commitment to the success of the not-for-profit and charitable sector in New Zealand is evidenced by us taking a pro-active stance with respect to financial accounting, audit and governance education in the sector. Accordingly we regularly present at a variety of forums.

In addition to our audit client base we have taken and continue to take an active involvement in assurance standard setting in New Zealand with one of our audit directors being the former chair of the New Zealand Institute of Chartered Accountants Professional Standards Board and representing New Zealand internationally in assurance standard setting. He is now a member of the NZAuASB.

We are a member of the Hayes Knight Australasian Group of independent firms and accordingly have an interest in how our financial reporting legislation and regulation translates across the two countries.

Specific Responses to Consultation Paper

Q1. Do you have any comments on the description of the problem definition?

While many charities currently comply with generally accepted accounting practice (GAAP) and have their annual financial statements prepared by competent accountants and audited by competent auditors we are also aware from first hand experience of many examples of the problems cited by Dr Sinclair in her study.

In our view unless charities are required by legislation to:

1. comply with GAAP, albeit one more appropriate to the not-for-profit sector as is currently being developed by the XRB, and
2. be required to be audited by competent auditors

then we foresee on-going problems in the sector with variable quality charity financial statements being presented. Without reliable comparable financial information the general public will be unable to assess the performance and financial health of charities to be able to make informed decisions as to their donations.

Q2. Do you have any comments on the description of the objective?

We concur with the objective of charity regulation as stated.

We believe the objective of the discussion paper to find an appropriate balance between the benefits of increased quality and reliability of financial statements if they have been assured and the costs of an assurance engagement to be an appropriate objective. Albeit that the objective is difficult to achieve, especially as in our observation that the smaller the entity size the greater challenges that entities often experience with compliance with generally accepted accounting practice.

We are aware of some criticism of these proposals from people within the sector claiming that mandatory audit will just add unnecessary compliance costs to the sector and that the sector as a whole is not well resourced and hence mandatory assurance is inappropriate. Our view is that poor quality financial information is currently not serving the sector well and is likely to be leading to suboptimal decisions being made due to unreliable or inadequate financial information.

Q3. Do you have any comments on the description of the options?

We believe that the main options described are the most likely viable options for providing independent assurance under current recognised professional assurance engagement standards.

Review:
We note that the International Auditing and Assurance Standards Board (IAASB) approved for issue, subject to confirmation by the Public Interest Oversight Board, ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*. ISRE 2400 (Revised), which is effective for reviews of financial statements for periods ending on or after December 31, 2013. This is a more comprehensive standard than the current Review Standard 1 (RS-1) applicable in New Zealand which it will replace. This more comprehensive international standard will have the benefit of being clearer as to what is performed in a review engagement. However it is more explicit as to requirements and as a result may be likely to add to the average cost in a review engagement.

From our observations, what is involved in a review engagement is not well understood in the sector. In fact, despite considerable educational activities of some parties, ourselves included, regarding the scope and purpose of a review engagement we suggest there is currently a greater "expectation gap" in relation to reviews than exists in relation to audits.

Of concern is that many seem to see a review as just a cheaper audit. When in fact it is providing a different level of assurance due to the different nature of work involved. Accordingly if review is to be used as an assurance option then in our view more needs to be done regarding education of what a review is and isn't by all parties involved, e.g. standard setters, assurance providers, Charities Commission, professional bodies such as NZICA etc.

We believe it important to highlight that reviews need to be performed by qualified assurance practitioners. They can require considerable professional judgement to be applied. We are concerned that there may be a perception that because they provide a lesser level of assurance based on a lesser level of work involved that there may be an erroneous assumption that they are easier to perform than an audit.

Our firm has been strong advocates in the past for reviews as an alternative to audit when an audit level of assurance is not required. We do however have some on-going reservations about the reliance that can be placed on a review for a very small organisation with limited accounting resources. This is due to a review relying to an extent on comparable quality financial information being able to be provided to the reviewer for analysis. If the quality of the underlying financial information preparation is seriously flawed then a review may not provide the desired assurance.

Compilation Engagements
We note that compilation engagements by a qualified accountant (ideally independent) have been dismissed as an option. We suggest this worthy of reconsideration.

We acknowledge that such engagements do not technically provide assurance. However part of the problem with accounting at the smaller end of the sector is that many organisations do not have anyone qualified in accounting preparing their financial statements. As such they commonly do not comply with accounting standards, more likely due to lack of knowledge rather than any intent. Hence the output is unreliable.

Whilst acknowledging that a compilation engagement is not an assurance engagement, we wonder if a compilation engagement by a qualified accountant at the smaller end of the market would not perhaps better meet the objective of ensuring reliable financial information. This would potentially help identify and address accounting issues earlier, and at their source, rather than these being identified then investigated as a result of a subsequent assurance engagement.

Notwithstanding it is not an assurance engagement, for small entities in the sector we believe that the involvement of a qualified accountant in preparing financial statements via a compilation engagement would be likely to serve to considerably improve the compliance with accounting standards, and therefore the reliability and comparability of financial information. Chartered accountants involved in compilation engagements are still bound by a code of ethics and professional standards. If they identify unusual matters during their work they are obliged to investigate these and bring them to the governing body's attention.

Q4. Do you consider that large charities should be required by legislation to have an assurance engagement completed?

Yes. Registered charities in effect are receiving a government grant on behalf of the general public by virtue of their exemption from income tax. They receive this because of their special charitable nature and purposes. Accordingly we believe it is appropriate that such entities should have a high level of transparency in their financial reporting as well as a high level of accountability to the general public.

An independent assurance engagement of financial statements carried out by assurance professionals in accordance with recognised auditing standards adds significantly to the credibility of financial information presented. Where significant sums are involved then an independent audit is a generally accepted element of best practice governance.

By definition we consider the general public an important stakeholder of charities. However as the general public does not have the power to specify an assurance engagement it seems appropriate to us that this should be required by legislation.

Q5. Assuming that mandatory assurance was to be introduced for large registered charities, do you consider that (a) all large registered charities should be required to have an audit completed or (b) that 'less large' charities should be required to have an audit or a review completed and 'larger' charities should be required to have an audit completed?

We believe that large charities should be required to have an audit of their annual financial statements. We refer to what is defined as "large" later under question 8.

We consider the concept of providing an option of a lesser level of assurance at a lesser cost for smaller entities to be sound, as long as the lesser level of assurance is well understood as to what assurance it delivers.

We believe there should always be the option for entities to opt up to a higher level of assurance should they choose to. We suspect that some in the sector will seek to do this to demonstrate the highest level of governance and hence credibility that they can.

Q6. Which measure or measures should be used for determining whether assurance is required and, if there are to be tiers, for setting the cut-off point between audit and review?

We believe that any measure used should provide as consistent a view as possible of normal operational levels. Otherwise entities are more likely to flip between levels and legislative requirements which we believe would be costly and confusing in the sector. On this point we suggest two-year compliance before a level is changed, or a two year to go up and one year to go down model.

We discount revenue as a consistently reliable measure. For any organisations involved in large project fundraising, such as for a capital asset such as a building, then the revenue can be greatly inflated for a couple of years then drop off significantly to return to normal operational levels.

Employee numbers are not usually a good determinant of scale of operations due to the widespread use of volunteers and the generally poor record keeping of their hours and input in the sector at present.

We agree that operational expenditure is generally the most consistently reliable measure of a charity's activity from year to year.

We acknowledge the views expressed in the paper regarding total assets. However we are also concerned that there are some charities with very large, and hence economically significant, asset bases. We expect there would be a general public expectation that such charities provide assurance over their financial statements to demonstrate that these were prepared in accordance with recognised accounting standards.

We would therefore prefer to see an "or" option using operational expenditure and total assets.

Q7. Do you prefer Option A, Option B (see paragraph 49) or another option in relation to assurers' qualifications?

We believe it is essential that the assurance provider is appropriately qualified in order to realise the benefits intended from legislating assurance.

Accordingly we favour option B of a combination of a lower proportion of registered charities being required to have an assurance engagement completed and requiring all of those engagements to be carried out by qualified accountants.

We note that there have been recent changes as regards qualifications of auditors of issuers in New Zealand with the creation of an issuer auditor licensing and audit firm registration regime. We do not consider that this level of qualification is required in the charities sector.

We are also aware of discussions within the Institute of Chartered Accountants to consider a specialist auditor designation which would involve those members having a specified level of audit experience and a requirement to undertake a level of on-going auditor specific education. We believe this would help improve audit quality and be beneficial to increase public reliance in the qualifications of these providing the assurance.

We note that it is only chartered accountants who hold certificates of public practice that are currently subject to NZICA's practice review inspection function.

Q8. What are your views on the tentative proposal for all registered charities with annual operating expenditure of $300,000 or more to have an audit completed and annual operating expenditure of $200,000-$300,000 to have a review or an audit completed?

We believe the threshold for mandatory audit is set too low and instead suggest a threshold of at least $500,000 annual operating expenditure before an audit is legislatively required. Beneath this amount we suspect that the cost of audit may likely exceed the benefit.

Another option would be to line up the size threshold with $2m band as specified under the new accounting standards framework. This has the elegance and simplicity of aligning legislative requirements. However we do have a concern from practical experience that many of the problems in financial reporting in the sector are from entities beneath this $2m threshold. Accordingly if the threshold is set too high then the objectives of the assurance will not impact a large enough segment of the sector.

If the tier structure is to be used we believe that the range between the two levels should be larger.

Q9. Do you consider that there should be a mechanism for the government to increase the dollar amounts from time-to-time to counter the effects of inflation?

Yes.

Q10. Do you have any views on the Ministry's estimates of costs and benefits?

While we appreciate what the MED was attempting to do by estimating costs we are concerned that the result may give an unrealistic expectation in the market. By attempting to provide "standard" or benchmark audit fees there is a risk that the market accepts these as standard and audit quality may be impaired if auditors then try to fit their audit testing into that perceived "standard" cost.

Audit, by its very nature is a difficult engagement to estimate the cost of with accuracy. The cost of an audit engagement is a function of the time involved and if problems are encountered then the auditor will incur more time in investigating these to determine the final impact on their audit opinion.
The audit standards also require certain mandatory procedures to be carried out in every audit, no matter the size, type or complexity of the entity. This means that the cost of audit can be disproportionate at the smaller end of the market, and that the impact of any issues requiring deeper audit investigation can also be disproportionate in terms of cost on smaller organisations. Related to this is the fact that smaller organisations generally have higher risks due to a lack of resources to obtain qualified accounting assistance and poor internal controls.

Another factor that needs to be taken into account is that many entities in the sector currently receive some form of pro-bono or semi pro-bono audit fee which will distort market average fee levels. However with the increased focus on audit quality from regulators, increased insurance costs, and more extensive and explicit audit standards an increasingly smaller number of auditors are willing to provide audit services, or their services at a discounted rate. We foresee a legislative audit requirement further exacerbating this trend meaning that the sector is more likely to have to pay commercial market rates for their audit services.

Q11. Do you consider that introducing a review requirement into law could encourage some charities that are currently having an audit carried out to switch to a review?

This will depend upon the acceptance and understanding of the review engagement as a viable form of assurance in the sector. The concept of a less expensive form of assurance is appealing to the sector but there does not seem to be a good appreciation of the difference in assurance from an audit.

There is also the practical conundrum that as a generalisation; the smaller the organisation the worse the accounting and internal control issues. This is understandable in the context of these smaller organisations generally not having the resources to procure accounting and systems expertise. A review engagement due to the level of detailed procedures is also less likely to identify and delve into these issues to the same degree that a full audit would.

Hence this poses a potential issue in that it is a review rather than an audit that is suggested for the smaller organisations. However offsetting this is that the $ involved in the smaller organisations will be less, which goes some way to offsetting this reporting risk.

Q12. Do you have any other comments?

We have some sympathy for the view that philanthropic organisations with charitable status that are only grant providers and do not seek any public funds could have a lesser public reporting requirement than charities actively seeking to raise funds from the general public. For example we are comfortable that such philanthropic organisations should be able to seek an exemption from public disclosure of their financial statements if the donors wish to remain anonymous. We are aware of some philanthropists who wish to perform their philanthropy privately and public disclosure may discourage their philanthropic activities. We would still expect that such charities should still be required to report to the Charities Commission, but just not have to publically disclose their financial statements.

However we would expect that following best practice governance that such organisations would still wish to have their financial statements audited and accordingly a legislative requirement to be audited would not be considered an additional imposition. Such a legislative requirement would still provide assurance that the philanthropic organisations are complying with GAAP.

We suggest it sensible that there be a 2 year threshold sensitivity system for any entity that moves between levels before they have to comply with the new level. Failure to have this sort of criteria, will likely result in unnecessary complication and costs if entities close to the cut-off levels have to keep changing.